PUBLIC EXCLUDED

greater WELLINGTON
THE REGIONAL COUNCIL

Report	**PE03.439**
Date	31 July 2003
File	CFO/21/3/1
Committee	**Policy, Finance and Strategy**
Author	**Greg Schollum, Chief Financial Officer**

CentrePort Property Matters

1. Purpose

To advise the Committee of a number of CentrePort property matters and to seek the Committee's endorsement of a specific property proposal currently being pursued by CentrePort, to enable Port Investments Ltd (as majority shareholder in CentrePort) to provide its conditional approval of the proposal.

2. Public Excluded

Grounds for exclusion of the public under section 48(1) of the Local Government Official Information and Meetings Act 1987 are that the public conduct of the whole or relevant part of the meeting would be likely to result in disclosure of information for which good reasons for withholding exists (i.e. commercial negotiations).

3. Background

The Council has long been vitally interested in Port property issues. This interest is reflected in the Port Company's Constitution which requires shareholder approval in the event that CentrePort wishes to sell any land or lease more than 20% of its assets.

The Exit Strategy which was prepared in 1999 fully canvassed the land issue and proposed a number of strategies which the Port Company should pursue including:

- Separation of port operational land from land available for alternate use.
- Improved utilisation of assets, including land.

Since 1999 CentrePort has been pursuing these strategies through:

Maintaining an overall port property plan

↓

which includes developing the concept of a business park on land available for alternate use, and

↓

pursuing specific property opportunities as they arise.

CentrePort currently operates its growing property activity as a business unit.

Since 1999 the Port Company has undertaken a number of relatively small scale property developments which have resulted in buildings with purpose built fitouts being tenanted by Telstra Clear and the NZ Rugby Football Union (NZRFU), with CentrePort reallocating its office to an existing, but previously underutilised, building.

These small scale developments have been funded within CentrePort's resources and are consistent with the key strategies identified in the Exit Strategy.

The end result has been improved asset utilisation, a diversified revenue base and an overall lowering of the risk profile of the Port Company as CentrePort has been able to increase its percentage of fixed revenue to total revenue.

The CentrePort Board is now at the stage where it wishes to bring an increased focus on property matters with a view to further enhancing the utilisation of assets of the company, thereby improving shareholder value.

At a recent meeting on 18 June 2003 called by the CentrePort Chairman, the Council Chairperson was advised of a number of property related matters as follows:

1. CentrePort's intention to move further into the property development business as part of bringing to life the proposed business park.

2. CentrePort's desire to restructure the CentrePort group by creating a separate property company (or companies) to increase the focus on, and transparency of, its property business.

3. CentrePort's intention to revalue its land assets to more closely reflect the true worth of the land, including the land available for alternate use.

4. CentrePort's desire to continue to pursue a specific property opportunity within the business park, for which they have already lodged a proposal with a prospective tenant.

4. CentrePort's intention to move further into the property development business

As noted above, CentrePort has over the past few years been quite active in small scale property developments through the redevelopment of the old CentrePort Head Office building and the adjacent Shed 39, now occupied by the NZRFU and Telstra Clear respectively. CentrePort has largely debt funded these developments and is now able to enjoy the increased flow of fixed revenue (rental streams). I understand that both buildings are subject to lease terms of approximately 10 years.

However, it is important to note that these developments have involved using existing buildings, where the focus has been on better utilising the existing structures.

The CentrePort Board is now keen to establish its proposed business park through the development of new buildings on vacant land – land that has been denoted within the port property plan as available for alternate use.

This, in effect, opens up a new ball game with a potentially new level of risk, depending on the development strategy employed by the Port Company. There is no doubt the CentrePort asset base (including land) is currently underutilised. The key question is who should take the risk in unlocking this value.

Essentially, it comes down to whether the Port Company should be a property investor of developed facilities, or a property developer taking the risks and earning the associated rewards of managing the development phase.

The CentrePort Board believes that, funding permitting, the Port Company should take the property developer role in circumstances where it is comfortable to do so.

However, in doing so, the Port Company has indicated that it intends to follow the key principles outlined below:

- No speculative property developments will be undertaken (any development involving the construction of a new building, or otherwise involving major capital expenditure, will only be undertaken if lease agreements are in place upfront with a suitable tenant or tenants).

- Property developments will not be undertaken if they have the potential to compromise port operations.

- Property developments will only be undertaken if they can be funded by CentrePort without requiring additional capital from shareholders.

- Property developments will protect the right of the Port Company in terms of land ownership, unless otherwise approved by the shareholders.

As majority shareholder the Council, via Port Investments Ltd, needs to determine its level of comfort with CentrePort moving into more large scale property developments and, if so, whether it considers the above principles to be both appropriate and complete.

As noted above, CentrePort has already undertaken some property development so the change being signalled is really one of degree, (i.e. large scale vs small scale developments) which is why we, as majority shareholder, are being consulted at this time.

To me, the issues for the shareholder come down to whether or not the increased focus on property development will sufficiently increase shareholder value while not exposing the company or the shareholders to unnecessary risks. It is therefore largely an exercise in risk management.

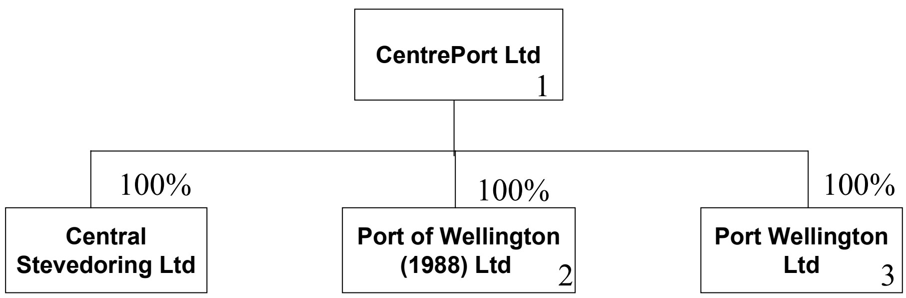
In my view, the Council and Port Investments Ltd should not be opposed to property development per se, rather the shareholders should support a continuation of the prudent management of risk demonstrated to date by CentrePort, in any future property development activity.

This report seeks a formal endorsement of this key principle.

5. CentrePort’s desire to restructure the CentrePort group by creating a separate property company

The CentrePort Board is currently investigating restructuring the CentrePort group of companies to bring more focus and transparency to the property side of CentrePort’s business.

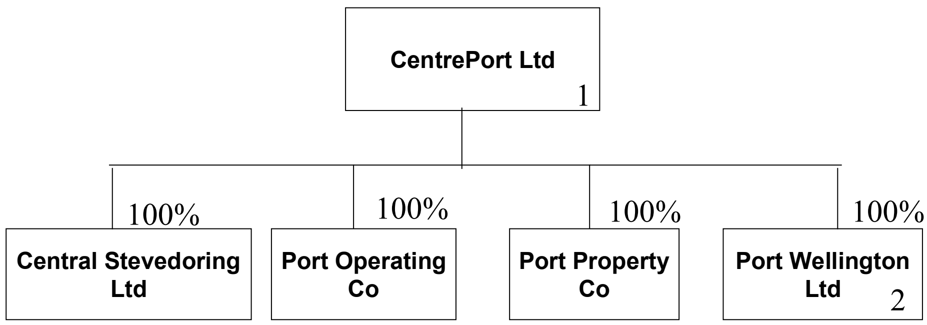
The current structure is as follows:



1. Owns land/paving and carries out Port operations
2. Owns all assets, other than land/paving
3. Non trading

As noted in section 3 of this report the property activity is currently managed as a business unit within CentrePort Ltd.

I understand that the CentrePort directors favour a proposed structure as follows:



1 Holding Company

2 Non trading

Within the above structure the CentrePort Board is investigating whether it would be preferable to continue to hold the land in CentrePort Ltd (as is the case now) or whether CentrePort Ltd should become purely a holding company for the Port Operating and Port Property companies, which in turn would own their own land.

Clearly, any transfer of land from CentrePort Ltd, the company in which Port Investments Ltd owns shares, down to its subsidiaries, would trigger the provisions in CentrePort Ltd's Constitution regarding the sale of land. This is important as, once it is transferred to a subsidiary entity, it would then fall outside of the provisions of the current Constitution. This highlights an aspect of the Constitution which needs a review.

On the basis of the proposed restructuring by the Port Company, I sought legal advice from Chapman Tripp as to what shareholder approval was required (if any).

Chapman Tripp's advice, which is attached as **Attachment 1**, concludes that irrespective of whether the land is retained within CentrePort Ltd (and leased to the Port Property Co and the Port Operating Co) or sold down to the Port Property Co and the Port Operating Co, the restructuring proposed is almost certain to require shareholder approval as the land looks likely to be sold or leased to a subsidiary.

Such approval is not being sought at this time but I have indicated to CentrePort that such approval will be required prior to the establishment of the Property Company as is proposed.

I see that the key benefits of the proposed restructuring are as follows:

- Increases focus on separate property and port businesses through the application of separate skills at management and/or board level.

- Enables ring fencing of certain assets for borrowing purposes (if required).

- Ensures absolute transparency and accountability over separate businesses with separate audit opinions required for each legal entity.

However, the options associated with restructuring need to be more fully explored than is possible in this report. I expect, therefore, that this will need to be the subject of a further report(s) over the next few months.

Irrespective of what option is finally decided upon, including retaining the current business unit structure, I expect that the focus on separately reporting the results of Port Operating and Port Property businesses will increase in future. This may well be an expectation that we should reflect in the CentrePort SCI for 2003/04. (Refer to report 03.438 on this order paper.)

6. CentrePort's intention to revalue its land assets

CentrePort has historically held land in its balance sheet at a cost of $36 million, dating back to the establishment of the Port Company in 1988.

However, the CentrePort Board considers that the land is worth considerably more than this (potentially $100m more than the book value) and the directors have signalled their intention to revalue all of the port land (both port operational land and land available for alternate use), with effect from 1 July 2003. As the valuation exercise is expected to take some time to complete and audit, the Port Company has sensibly decided not to try and incorporate the revaluation into the 2002/03 financial statements, by making the revaluation effective 1 July 2003.

The independent valuation will need to be conducted in accordance with Approved Accounting Standards in NZ (FRS-3 Property, Plant and Equipment) which requires assets being revalued to be valued at fair value. Implicit in the fair value of an asset is assessment of its highest and best use. This means the potential for alternate use opportunities which are feasible and legally possible should be fully reflected within the land revaluation.

The revaluation of land has a number of implications for both CentrePort and for the shareholders as follows:

Implications for CentrePort:

- All other things being equal, the revaluation of land assets will strengthen CentrePort's balance sheet, by improving the Port Company's ratio of debt:equity.

- Recognising the "value" of the Port Company's land in its financial statements (which are audited) may give lenders a higher level of comfort over the value of the land than they would get from a standalone valuation.

Implications for Shareholders;

- The strengthening of the Port Company's balance sheet will flow through to a stronger GWRC consolidated balance sheet.

- By increasing the asset base of CentrePort the Port Company's reported performance will look worse when viewed as a percentage of equity or assets employed.

- The increased asset base within the Port Company's balance sheet will increase the $ thresholds above which shareholder approval will be required pursuant to the Constitution.

This report is not seeking specific approval to the revaluation of assets – it is purely a matter for the Committee to note and recognise the linkages between the planned revaluation exercise and the other property matters within this report.

7. Specific Property Development Opportunity currently being pursued by CentrePort

CentrePort is currently pursuing a specific property opportunity as it looks to secure an anchor development for its proposed business park.

CentrePort has responded to a request for proposal from a prospective tenant and it is understood that the CentrePort proposal is one of three or four options which the prospective tenant is currently considering.

At the time of writing this report I have been advised that the CentrePort proposal remains a 'live' proposal with the next key decision point for the tenant on 8 August 2003, when it is expected a shorter "short list" will be announced.

Although it looks likely that shareholder approval of this proposal is not required (refer **Attachment 1** for the legal advice we have received) CentrePort has sensibly decided to seek the approval of shareholders given the potential implications on the Port Company and shareholders of proceeding with the proposal.

The proposal is for a commercial property development within the proposed business park with estimated external costs to be funded of approximately $60 million, this excludes the value of land which CentrePort already owns. CentrePort plans to debt fund the whole of the estimated $60 million development cost.

Given the significance of the proposal to the Port Company, the WRC Holdings Group and the Council, I considered it was prudent to commission an independent peer review of the various aspects of the proposal as follows:

- Legal review (Chapman Tripp)
- Financial and Commercial review (PricewaterhouseCoopers)
- Property review (O'Brien Property Consultancy)

Legal Review (Chapman Tripp)

As the proposal is still largely at concept stage the legal review conducted by Chapman Tripp (refer **Attachment 1**) has been primarily limited to commenting on the nature of shareholder approval required for both the restructuring of the Port group (refer section 5 of this report) and the specific property opportunity outlined in this section of the report.

However, it is expected that if CentrePort's proposal proceeds, there will be a requirement for a legal review of documentation at a later date to ensure our interests as shareholders are appropriately protected. This has been noted as one of the recommended conditions attached to any shareholder approval which may be given by Port Investments Ltd.

Financial and Commercial Review (PricewaterhouseCoopers)

PricewaterhouseCoopers were asked to review the financial and commercial aspects of the specific property opportunity, with primary emphasis on the implications for shareholders.

Their report is attached as **Attachment 2**.

The key points to emerge from the PricewaterhouseCoopers review are as follows:

- As the development will be debt funded by CentrePort the increased debt will reduce the company's and the shareholders' flexibility to undertake further borrowing for other things or increase the cost of such borrowing.

- The development is projected to provide a good rate of return to the company but poses some key risks which need to be appropriately managed:

  - Construction risk (ability of CentrePort to cap the cost of construction through an appropriate contracting strategy with a high quality contractor)

- Funding risk (availability of funding at an appropriate cost with minimal risk of that cost increasing significantly)
- Credit risk (seen as minimal given the nature of the tenant)

  These risks, particularly construction risk and funding risk, are exacerbated by the size of the project.

- As surplus cashflow is used to repay debt, fund capital expenditure and pay shareholders dividends there is a risk that if the financial projections aren't met, dividends to shareholders may suffer.

However, PricewaterhouseCoopers also note there are risk mitigation strategies available to CentrePort to help manage the above risks/issues including the option of selling the development once it is complete.

The difficulty is ascertaining at this time the exact nature of the risks and the likely success of the risk mitigation strategies.

Property Review (O'Brien Property Consultancy)

O'Brien Property Consultancy was asked to review the property opportunity from the point of view of whether or not the proposal "stacks up" as a property deal.

Peter O'Brien has concluded in his report (refer **Attachment 3**) that the property opportunity being pursued by CentrePort "represents a fantastic opportunity upon which to base any property company". Mr O'Brien sees that the development proposal would provide the necessary anchor to enable the whole business park concept to gather momentum, and should be actively pursued.

The fact that the prospective tenant is a "blue chip" tenant and prepared to enter in to a net lease are features which make the proposal very sought after in the property market.

While Mr O'Brien's report contains comment on a number of detailed matters, none of these should detract from the overall conclusion reached by Mr O'Brien that it is a good deal from a property perspective and one which fits well with CentrePort's strategic intent of developing the proposed business park.

Other matters to consider:

⇒ What resource consents will be required?

I understand that CentrePort has been in discussions with WCC and that what is proposed is largely a permitted activity within the Port Company's existing resource consents.

Therefore, CentrePort do not expect any obstacles from a resource consent perspective.

⇒ What about Treaty issues?

CentrePort advises that the extent to which Treaty issues may apply has been assessed and CentrePort is satisfied that there are no Treaty issues related to this particular development.

⇒ What does the minority shareholder think about the proposal?

Horizons Regional Council, which owns 23% of CentrePort has already considered the specific property opportunity and has approved the transaction, subject to the proposal receiving approval from Port Investments Ltd.

⇒ Is the proposal consistent with the Northern Gateway Project (Mayor's 50 year vision for the waterfront)?

The CentrePort Chairman advised the Council on 22 July 2003 that in his view the proposal was consistent with the Mayor's 50 year vision for the waterfront but that the costs of relocating the port (as envisaged in the Mayor's 50 year vision) would be prohibitive. Therefore, notwithstanding the low probability of the 50 year vision being able to be successfully implemented, the specific property opportunity is not seen as being in conflict with that vision for the waterfront.

However, given the political sensitivities involved, it will be wise to ensure CentrePort has undertaken the necessary consultation with key stakeholders (including the Mayor of WCC) prior to irrevocably committing to the proposed development.

⇒ What is the likely impact on the Council's credit rating?

Informal discussions with Standard and Poor's (S & P) suggest that S & P would prima face view the impact of the proposed development as negative on Council's credit rating. However, their stance is likely to be significantly tempered by the quality of the tenant underpinning the development and the nature of the lease (i.e. a net lease is seen as a low risk option compared with a gross lease). Therefore, it is uncertain whether this proposal would affect the Council's credit rating.

This can be further explored if the project proceeds to the next stage. However, even if S & P determine the Council's credit rating should reduce I would be very surprised if this would be more than one notch (i.e. from AA to AA-). This would return the Council to the credit rating we enjoyed prior to the recent upgrade and would have only a marginal impact on Council's cost of funds.

⇒ Is the proposed property opportunity consistent with the key principles that CentrePort has indicated it will follow in all property developments?

In section 4 of this report I summarised the key principles that CentrePort indicated it intends to follow in all future property developments.

Key Principles	This specific property opportunity
No speculative property developments	This will only proceed with a signed lease agreement with a quality tenant (upfront).
No compromise to port operations	The business park is separate from core port operations and therefore is not expected to impact on port operations.
No funding required from shareholders	The proposal is being funded from debt, rather than additional capital from shareholders.
Port Company to retain land ownership	The proposal retains land ownership with CentrePort

From the above analysis it is clear that this proposal is consistent with the key principles previously outlined by CentrePort.

⇒ Is the decision by the Council to endorse or otherwise the specific proposal a significant decision in terms of the Local Government Act 2002?

Whether or not a decision is considered to be significant is determined by the Council's significance policy.

The Council's significance policy includes the following:

> "when determining the question of significance of proposals and decisions in relation to issues, assets or other matters the Council will determine the extent to which:
>
> - The likely consequences or impacts of the issue, asset or other matter on the current and future social, economic, environmental and cultural wellbeing of the greater Wellington Region.

- The issue, asset or other matter have a history of generating wide public interest within the greater Wellington Region or New Zealand generally".

The policy also includes the following criterion which is relevant in this case.

"The Council will use the following to determine whether a proposal or decision is significant.

- To what extent will the proposal or decision result in the sale or replacement of, or significant addition to a strategic asset (or a significant portion thereof) as defined by the Act or listed in this policy."

The policy goes on to list Council's ownership in CentrePort as a strategic asset.

It is therefore not an unreasonable conclusion to reach that this decision is likely to be a significant decision in terms of the Local Government Act 2002.

Section 79 of the Local Government Act 2002 puts a lot of discretion in the hands of the Council as to the:

- extent to which different options are identified and assessed
- degree to which benefits and costs are to be quantified
- extent and detail of the information to be considered

depending, inter alia, on the nature of the decision and the circumstances in which it has to be taken.

Given the processes followed by CentrePort in relation to this issue, including the consultation it has undertaken on its Port Property Plan, the independent peer review process conducted by Chapman Tripp, PricewaterhouseCoopers and O'Brien Property Consultancy on behalf of the Council and Port Investments Ltd, and the time available to consider this particular proposal, I consider that the approval being taken by the decision before the Council is consistent with the type of process contemplated by the Local Government Act 2002.

Sections 77 and 78 of the Local Government Act 2002 detail the requirements in relation to making decisions and the requirements for councils to consider (known) community views in relation to these decisions.

As noted above, the processes completed to date by both CentrePort and the Council, coupled with the condition noted within this report for CentrePort to further consult with key stakeholders as necessary, provide a good audit trail of how the Council and Port Investments Ltd have considered this commercially sensitive matter.

Therefore, although the matter is likely to be a significant decision in terms of the Local Government Act 2002, I believe the processes followed to date and those which have been mapped out to be followed over the next few months mean the Council is in compliance with the Local Government Act 2002.

What is the nature of approval being sought at this time?

I am sure CentrePort accepts that, in asking for shareholder approval of a proposal which isn't yet fully developed, any approval can only reasonably be granted with conditions attached. (In fact, this is the position that the CentrePort Board itself is in at present).

The key questions are:

- What should those conditions be? and
- How should the Council satisfy itself that those conditions have been subsequently met?

In my view, it is both prudent and reasonable for Port Investments Ltd to attach certain conditions to its approval of the specific property opportunity currently being pursued by CentrePort. Based on the advice of Council's independent peer reviewers, such conditions should include:

- Construction risk being appropriately mitigated (e.g. through an appropriate guaranteed maximum price contracting strategy with a high quality contractor)

- Funding risk being appropriately mitigated (e.g. through an appropriate funding agreement, satisfactory security arrangements and prudent hedging strategy)

- Legal risk being appropriately mitigated (e.g. through having appropriate legal review of all key documents associated with the proposal including being satisfied that the land on which the specific property proposal is undertaken cannot be transferred out of the control of the CentrePort group without the prior consent of CentrePort Ltd shareholders)

- Any impact on Port operational requirements being appropriately mitigated (e.g. identifying any potential impact on the Port's operational requirements and having a clear strategy for catering for such impacts)

- Key stakeholder risk being appropriately mitigated (through targeted consultation with key stakeholders so as to minimise any potential negative perception associated with the development)

Perhaps the more difficult question to answer at this time is how should the Council satisfy itself that those conditions have been subsequently met.

One approach would be for the shareholders to decide that total reliance on the CentrePort Board is appropriate and at the other end of the scale is the shareholders carrying out further independent assessments at an appropriate time (to suit CentrePort's own sign off timetable).

It is a delicate balance between trusting those people who are rightly accountable for the success of this proposal (the CentrePort Board) and seeking independent comfort as the satisfaction of any conditions laid down.

In my view, the Stadium project, and the Council's contribution thereto, provides the model which we should be following in this case. In the case of the Stadium, the Council's approval was in stages with final approval only granted once the Council was satisfied the conditions had been satisfactorily met.

In this case, if this approach is followed, it will require close ongoing liaison with CentrePort to ensure our process does not unduly interfere or delay their own risk management process. Given the CentrePort Board has already given the proposal its conditional approval I expect that the above conditions from shareholders should be consistent with, and no more onerous than, the key conditions the CentrePort Board itself should have on the proposal.

8. Communications

The results of the Committee's deliberations need to be urgently communicated to Port Investments Ltd which also meets on 5 August 2003(at 3 pm).

Following the Port Investments Ltd meeting, the resolutions of the shareholers should then be promptly communicated to CentrePort.

No other communication is seen as appropriate at this time.

9. Recommendations

The Committee recommend that Council:

(1) ***receive*** *the report and note its contents.*

(2) ***note*** *the following key principles that CentrePort intends to be governed by in any future property developments.*

- *No speculative property developments will be undertaken (any development involving the construction of a new building, or otherwise involving major capital expenditure, will only be undertaken if lease agreements are in place upfront with a suitable tenant or tenants).*

- *Property developments will not be undertaken if they have the potential to compromise port operations.*

- *Property developments will only be undertaken if they can be funded by CentrePort without requiring additional capital from shareholders.*

- *Property developments will protect the right of the Port Company in terms of land ownership, unless otherwise approved by the shareholders.*

(3) ***endorse*** *CentrePort's stated intention of moving further into the property development business as part of bringing to life its proposed business park, subject to future developments being consistent with the key principles detailed in resolution (2) above.*

(4) ***note*** *CentrePort's plans to restructure by creating a separate property company (or companies) will almost certainly require shareholder approval and will therefore be the subject of a further report to the Committee and to Port Investments Ltd.*

(5) ***note*** *that CentrePort intends to revalue its land in accordance with Approved Accounting Standards with effect from 1 July 2003.*

(6) ***note*** *that CentrePort is currently pursuing a specific property opportunity as detailed in this report on which the Port Company has sought shareholder approval.*

(7) ***note*** *that the Council's consideration of the specific property opportunity currently being pursued by CentrePort is likely to be a significant decision in terms of the Local Government Act 2002.*

(8) ***note*** *the specific property opportunity currently being pursued by CentrePort is consistent with the key principles detailed in resolution (2) above.*

(9) ***endorse*** *the specific property opportunity currently being pursued by CentrePort on the proviso that Port Investments Ltd's approval of the opportunity is conditional on the shareholders satisfying themselves that the certain conditions have been met, including:*

- *Construction risk being appropriately mitigated (e.g. through an appropriate guaranteed maximum price contracting strategy with a high quality contractor)*

- *Funding risk being appropriately mitigated (e.g. through an appropriate funding agreement, satisfactory security arrangements and prudent hedging strategy)*

- *Legal risk being appropriately mitigated (e.g. through having an appropriate legal review of all key documents associated with the proposal including being satisfied that the land on which the specific property proposal is undertaken cannot be transferred out of the* *control of the CentrePort group without the prior consent of CentrePort Ltd shareholders)*

- *Any impact on Port operational requirements being appropriately mitigated (e.g. identifying any potential impact on the Port's operational requirements and having a clear strategy for catering for such impacts)*

- *Key stakeholder risk being appropriately mitigated (through targeted consultation with key stakeholders so as to minimise any potential negative perception associated with the development)*

*(10) **request** officers to advise the Directors of Port Investments Ltd of the conditions which should be attached to any approval of the specific property opportunity by Port Investments Ltd.*

*(11) **note** that the matters included in this report have highlighted the need for a review of the CentrePort Constitution and that officers be requested to report back to the Committee on this matter.*

Report prepared by:

Greg Schollum
Chief Financial Officer

Attachment 1: Peer Review Report by Chapman Tripp

Attachment 2: Peer Review Report by PricewaterhouseCoopers

Attachment 3: Peer Review Report by O'Brien Property Consultancy Ltd